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14 November 2008

Dear Clive & Richard,

CAG – DRAFT CONCLUSIONS ON TRANSMISSION TARIFF HARMONISATION IN IRELAND AND NORTHERN IRELAND

Thank you for this further opportunity to comment on the gas transmission tariffs under CAG and the opportunity to take part in the CAG forum held on 7 November. The discussion at the forum was lively and provided a good backdrop to the narrowed down options for change.

We note the commitment by the RAs to defer consideration of the Capacity to Commodity charging split within the transmission tariff structure. The effect this has on investment decisions should not be underestimated and we look forward to contributing further on this important aspect in due course.

In the meantime, and in keeping with our former responses on this subject, we agree with the general thrust of the RAs' conclusions, i.e. Postalisation is not the answer, particularly in view of the significant complexity involved in balancing the tariffs across the two jurisdictions, aside from the resultant effective collapse of the IBP. Ultimately, customers will have to pay for the absence of market based signals that affect investment decisions and efficiency, leading to an increased risk to security of supply.

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An Entry/Exit approach on the other hand, underpinned by a marginal cost philosophy, will result in a more market responsive and network efficient outcome, and is also aligned with the European Third Package. We also agree that basing the Entry model on the existing entry points is preferable (we comment further on combining the ICs and SNIP below). Retaining the dual Exit approach (one for each jurisdiction) will also provide a good tariff framework to allow jurisdictional tariff differences to be effectively managed.

The two particular aspects upon which we now comment further for this response, are as follows:

- Whether or nor a combined SNIP & IC is appropriate (“Moffat bundling”)? and
- The form of the IC mitigation measures.

Moffat bundling

Viridian accept there are advantages through bundling, i.e. smearing charges across SNIP and the ICS, and some operational efficiencies to be gained. Even the offsetting of the potential IC under-utilisation has some merit. However, this must be weighed against a number of significant disadvantages, including at its most base level, it will be at the expense of efficient network management principles. Indeed, we suggest the bundling of Moffat reduces transparency and therefore works against the general thrust of European policy on cross jurisdictional interconnectors and its drive for increased transmission transparency.

We therefore recommend there should be two entry points, one for SNIP and one for IC1/IC2.

Efficient network management principles should be integral to the all-island transmission approach and we consider that a combined Moffat will shift the emphasis away from cost relative pricing and lessen investment signals. It is also complex to integrate and get right given the differing RAV and recovery methodologies (SNIP is mutualised, IC1&IC2 are not), and the differing ownership issues.

Efficient networks require Shippers to book capacity on what is deemed to be most efficient in terms of getting gas around the RoI and NI network, i.e. that which is most cost effective in terms of the customers they will serve from different parts of the network. SNIP and the IC1/IC2 land at different points and in different jurisdictions, and so harmonising interconnector charges simply because they come from a single source, i.e. Great Britain, could lead to distortions. We argue, the landing of gas at optimum points around the network must be market based in order to help drive further investment across the island,

and that market distortions are not allowed to creep into the equation leading to potentially inefficient investment.

Critically, it will also be important to ensure that neither the North nor the South are able to capitalise from tariff advantages at the expense of the other. As such, the approach should avoid creating an environment that is conducive to cross jurisdictional arbitrage which could be the case with a bundled Moffat. In this context, the South-North pipeline also plays a fundamental role, acting as it does as a cross-border exchange point for gas. Not knowing how the South-North pipeline will be managed under CAG makes it all the more difficult to fully consider the effects of Moffat bundling.

We conclude, keeping SNIP and the ICs separate will ensure that Shippers booking capacity via SNIP or IC1/IC2, will do so based on what is most cost effective in terms of the customers they serve from different parts of the network. It is also avoids a reduction in transmission transparency and is more practical.

Consequently, this approach not only reinforces at least three of the CAG market assessment criteria: the ‘Developing the Industry’, ‘Security of Supply’ and the ‘Transparent and Practical’ objectives, but it also avoids unnecessary regulatory intervention.

IC Mitigation

The consultation argues for mitigating action to counter the effects on the marginal cost pricing system of under-utilisation of the Interconnector. The options are effectively boiled down to:

- partial stranding of the asset;
- reprofiling of asset revenues (averaging out the trough in consumption);
- moving part of the asset revenues; and
- setting a minimum booking level (filling in the trough).

In our first response, we focused on two key concerns. First, regulatory intervention may well have unintended consequences. Second, regulatory intervention in this manner introduces additional regulatory uncertainty and therefore risk into the market, and this will affect future investment decisions. Our view has not changed.

The modelling to-date takes us only so far, and will be prone to forecast errors. No matter how hard we try, we cannot possibly predict the prevailing market conditions two or even three years hence, indeed who could have predicted the significant delay to the Corrib development or the recent energy market volatility.

Any solution decided upon may not therefore be optimal when the time comes to deploy the mitigation - the underlying assumptions will undoubtedly shift. Thus, it will not only require very careful design, but its trigger and deployment will also need to be carefully timed. Too soon and the effects will be inefficient, too much and it may damage future investment and competition.

We agree it is important to protect customers, however this must be managed in a way that does so without distortional effects on the market. Further, we argue that no subsidy type solution should be introduced without the ability to define the trigger and the flexibility to adjust or unwind the mechanism in the event that market conditions change.

We note that Commission's commitment at the Industry Forum on 7 November to ensure of "…only intervening if absolutely necessary". We also note that any mitigation must be efficient, fair and proportionate and we welcome this commitment. This would suggest that for any given solution, a set of key market tests would need to be designed and then monitored, with the mitigation only being deployed if and when the market conditions are right and the tests met.

Indeed, any measures that are subsequently deployed would require careful ongoing monitoring and must also be capable of flexing to ensure that market distortions do not occur; for example, that over recovery does not transpire and that attempts to introduce subsidies to mitigate the effects do not become expensive mistakes. We therefore conclude that, taking regulatory action to mitigate the effects of under-utilisation of the ICs is immensely complex and fraught with risk.

Our approach would therefore first entail defining the market triggers (both the event and duration) and then monitoring the IC underutilisation on a quarterly basis. If and when the IC investment is unduly exposed through under-utilisation, we recommend a 'cap' approach, noting this is also consistent with the BGN philosophy (albeit we advocate a separate SNIP and IC1/IC2). This would mean defining a nominal market value at which the interconnector revenues should be set and any subsequent under-utilisation adjustments being applied for each forthcoming gas year (to reduce charging volatility and impact on the market).

BGN suggests capping the interconnector charge at an indicative value of transporting gas over the interconnector as €107/peak day MWh, and any short fall recouped via the Exit tariff. We agree any material shortfall should be recouped via the Exit charge, however we require further data and a better understanding of all the inputs before we can judge whether the cap should be set at €107/peak day MWh, or some other value. Critically, it will be important to isolate any affects from the cap that are not directly or indirectly attributable to interconnector under-utilisation.

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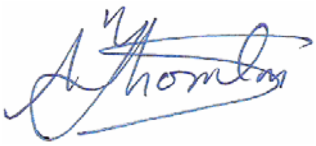
We therefore recommend BGN circulates the relevant data, inputs and calculation, to allow a more informed review to be undertaken and for Shippers to be given the opportunity to contrast this with their own analysis.

As and when IC revenues recover, corresponding adjustments would then need to be made to the Exit charges until the natural position is fully restored and ‘business-as-usual’ is resumed.

In summary, we agree with the general thrust of the draft conclusions and recommend an approach for transmission tariff harmonisation that is fundamentally market focused and avoids regulatory intervention unless it is proven to be absolutely necessary. We recommend keeping SNIP and IC1/IC2 as separate exit points, and a capped approach to manage the interconnector under-utilisation.

Please do not hesitate to contact us if we can provide further information.

Yours sincerely



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